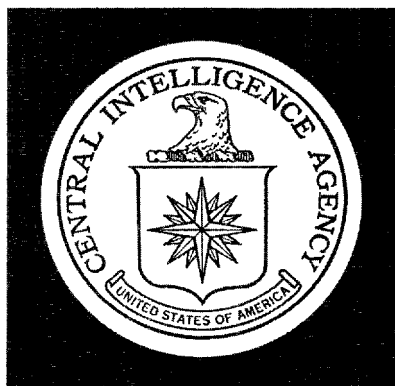


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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

*Foreign Trade in the Economic Policy
of Czechoslovakia*

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July 1968

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
July 1968

INTELLIGENCE MEMORANDUM

Foreign Trade in the Economic
Policy of Czechoslovakia

Summary

Czechoslovakia depends heavily on imports of raw materials, including nearly all the crude oil it uses; much of the ores, rubber, and textile fibers; and part of the nonmetallic minerals and foodstuffs. Imports of raw materials amounted to US \$1.2 billion in 1966, or 45 percent of total imports. Raw materials come largely from the USSR and other Communist countries and from less developed countries in the West. Czechoslovakia pays for them with manufactures, chiefly machinery, that can be sold in the developed Western countries only in small quantities and at large discounts.

Economic dependence on the USSR -- which alone furnishes more than 40 percent of raw materials imports -- has not stopped the new leadership from going ahead with major political reforms. Soviet deliveries to Czechoslovakia have continued despite Soviet concern about the reforms. A reported delay in wheat shipments this spring -- if it did indeed occur -- was not regarded as a serious threat by Czechoslovakia. The USSR seems to be relying primarily on military gestures and political pressure, rather than economic pressure, to keep the new leadership within acceptable bounds.

Note: This memorandum was produced solely by CIA. It was prepared by the Office of Economic Research and was coordinated with the Office of Current Intelligence.

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Economic dependence on the USSR and other Communist countries is, however, a major obstacle to reviving the economy. Over 70 percent of Czech trade has been with Communist countries. Producing by command for guaranteed markets has led to massive inefficiency and has undermined the competitive position of Czechoslovakia's exports. Failure to deal with these weaknesses was a big factor in the fall of the Novotny regime.

Novotny's successor, Alexander Dubcek, has sworn to do better. Some of his economic advisers -- especially Professor Ota Sik -- would like to put the indispensable trade with the USSR and other Communist countries on a more businesslike basis by decentralizing decisions on trade and eliminating the ever-increasing exchange of obsolete and often substandard manufactures. Czechoslovakia would lose on balance by such reforms, but the new leadership might be willing to accept a loss as part of the cost of reimposing the "discipline of the market" on its own enterprises.

The outlook for bringing about such changes in trade among Communist countries, however, is not encouraging. Domestic opposition in Czechoslovakia would be strong, especially among workers, for many plants would have to cut back operations or close down, and only the strongest firms would benefit. And it is not very likely that Czechoslovakia could obtain the necessary support among its main trading partners. The USSR would benefit economically from trade reforms. But reforms would face the adamant opposition of the East German and Polish regimes, which have strong political as well as economic grounds for keeping things as they are. Hungary might be willing to go along, and Yugoslavia would be enthusiastic, but such support would not count for much with the other countries.

A possible escape from the built-in inefficiency of trade with the Communist world is a gradual shift of Czechoslovakia's trade toward the West, a course long favored by the more extreme reformers. The costs and difficulties, however, are no less than those involved in changing the conduct of trade with other Communist countries. To shift trade to the

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less developed countries of the Free World has been a favorite idea even with the Czech conservatives, and possibilities for further expansion certainly exist -- especially trade with oil-producing countries. But in general the trade has been limited by Czechoslovakia's need for the commodities offered, most of which are not in strong demand on the world market. Where the less developed countries have alternative cash markets, Czechoslovakia, too, must pay cash. Thus trade with these countries leads back to the main problem in all trade with the West, that of earning hard currencies -- a problem that has proved quite intractable. So long as there are easier protected markets at home and in barter trade, Czech enterprises will not make the effort. The best of Czech goods are hard to sell in competitive markets, even with great effort. The prices obtained are so low that trade with the West usually involves a substantial loss, except in the cases in which purchases in the West open bottlenecks in supply.

An appreciation of these difficulties has led Czech economists -- and many senior officials -- to conclude that large-scale foreign help is essential if Czechoslovakia is to make itself more competitive. Some immediate help would be useful in any case to allow Czechoslovakia to manage its foreign trade more efficiently; its existing reserves are much too small for that. Help is needed to reorganize and modernize selected export industries. But what is most critical, if Czechoslovakia is indeed to undertake sweeping economic reform, is long-term aid to finance deficits in the balance of payments, so that it can maintain consumption while restructuring industry and shifting trade patterns. The USSR almost certainly will not provide aid enough to meet these needs. Czechoslovakia therefore must look to a handful of Western countries -- the United States, West Germany, France, and possibly others -- and the World Bank. Czechoslovakia probably will not accept large-scale Western aid unless it undertakes real economic reforms to improve the quality and mix of its products.

Character of Czechoslovakia's Trade

1. The changing needs of a small industrial nation, the ill effects of past economic policies, and the constraints of barter arrangements are all reflected in Czechoslovakia's foreign trade. The country has long been a net importer of materials and a net exporter of manufactures. Since World War II, however, the composition of imports and exports has changed radically. Imports of foodstuffs, non-metallic minerals, and petroleum are several times larger than before the war, mainly as a result of industrial development and technical change. Imports of ores and metal scrap are also much larger, in spite of intensive working of domestic resources, because the regime has pushed steel output and the production of machinery -- a policy initiated by the Germans in World War II. On the other hand, imports of hides, furs, and skins and textile fibers are no greater than in 1937, because the regime has attached slight importance to expanding light industry. *(The principal imports of raw materials in 1937 and 1966 are shown in Table 1.)* Exports bear the mark of the same policies. Sales of machinery and equipment, which came to only 5 percent of the total in 1937, now amount to almost one-half. At constant prices their value is some 20 times the 1937 level. But exports of other manufactures, which were about 65 percent of the total in 1937, have dropped to about 30 percent. With the main exception of exports of chemicals and iron and steel products, which have increased greatly, they are below the prewar level.

2. Shifts in commodity composition have been accompanied by a sweeping geographic reorientation of the trade. In 1937, only about one-sixth of Czechoslovakia's trade was with the USSR and Eastern Europe. In the early postwar period the share rose as a result of increased Soviet influence in Central Europe, but even in 1948 -- the year of the Communist takeover -- it still was only 40 percent. Thereafter, trade with the West was deliberately cut until in 1953 it stood at less than one-half the 1948 level. Meanwhile trade with the Communist countries continued to rise; by 1953 it stood at more than three-fourths of Czechoslovakia's total trade. Since then the share has never been less than 70 percent.

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Table 1

Imports of Selected Raw Materials by Czechoslovakia
1937 and 1966

	Thousand Metric Tons	
	1937	1966
Grain and fodder	172	2,097
Meat and meat products	15	80
Fish and fish products	24	47
Bituminous coal	1,443	4,030
Iron ore	1,945	9,333
Crude oil and petroleum products	485	7,141
Cotton	113	113
Wool	28	20
Jute	42	15
Sawn timber <u>a/</u>	271	163
Hides, furs, and skins	42	44
Natural rubber	18	46

a. In thousand cubic meters.

3. Nearly one-half of Czechoslovakia's trade with the Free World, moreover, has been with the less developed countries. Much of it can fairly be described as barter trade, like trade with the Communist world. Thus most of Czechoslovakia's trade is conducted outside the open market. By relying on barter trade, Czechoslovakia has been able to minimize adjustments to changes in demand, at the price of becoming less and less competitive in the open market and of having to accept a mix of imports much less satisfactory than it could otherwise obtain. In this

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way foreign trade has contributed greatly to the economic inefficiency now under attack by the reformers.

Sources of Raw Materials

4. Czechoslovakia depends on imports, chiefly from the Communist countries and the less developed countries, for at least part of its supplies of most raw materials. It is a net importer of all major raw materials except uranium and wood. Czechoslovakia imports nearly all the crude oil it uses; part of the hard coal (though it is a net exporter of coke and brown coal); much of the iron ore, ferroalloys, and nonmetallic minerals; and the greater part of the textile fibers and hides, furs, and skins. Czechoslovakia is also a net importer of foodstuffs, including grain, meat, and fruits and vegetables. Gross imports of raw materials* in 1966 amounted to \$1.2 billion, or 45 percent of the total value of imports. The importance of imports of raw materials to Czechoslovakia is indicated in Table 2.

5. The Communist countries supply most of the foodstuffs, tobacco and beverages, and fats. The main imports from the Free World in 1966 included fish (from Scandinavia and Japan), corn (from the United States), tropical foods (from the less developed countries), and tobacco (from Greece and Turkey). In some years Czechoslovakia also imports wheat (from Canada and France) on a large scale. The only crude materials that come preponderantly from the Communist world are ores and nonmetallic minerals; the other main source of supply is the less developed countries, which furnish substantial amounts of chrome ore, manganese ore, pyrites, and phosphates as well as some iron ore. The less developed countries supply the greater part of the hides, furs, skins, oilseeds, and textile fibers and

* Food and live animals; beverages and tobacco; crude materials; animal and vegetable oils and fats; and mineral fuels -- that is, classes 0 through 4 in the Standard International Trade Classification (SITC). Other significant deficiencies in raw materials are filled by imports of manufactures, which are not included in the above total -- in particular, manufactured fertilizers (under class 5, chemicals) and nonferrous metals (under class 6, manufactured goods classified chiefly by material).

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Table 2

Dependence of Czechoslovakia on Imports of Raw Materials a/
1966

	Total	Imports as a Percent of Total Supply	
		Of Which	
		From the USSR	From Other Communist Countries
Crude oil	97	95	0
Hard coal	14	7	7
Iron ore	81	66	0
Manganese ore	76	40	12
Chrome ore	100	26	30
Copper	74	59	N.A.
Zinc	92	37	24
Lead	67	47	4
Magnesium	100	100	0
Pyrites	25	10	4
Sulfur	47	7	24
Phosphates	51	33	0
Natural rubber	100	0	0
Synthetic rubber	86	33	0
Wool	91	17	0
Cotton	100	54	N.A.
Wheat	31	31	0
Barley	8	7	0
Corn	37	0	5
Meat	12	5	4

a. Including nonferrous metals.

almost all the natural rubber. Developed countries deliver substantial amounts only of textile fibers. Finally, practically all of the crude oil and petroleum products imported by Czechoslovakia come from the Communist world, chiefly from the USSR.

6. The USSR is the largest single exporter of raw materials to Czechoslovakia, furnishing more than 40 percent of Czechoslovakia's gross imports of raw materials. Other Communist countries and the less developed countries furnish most of the rest. The shares of the main groups of trading partners in imports of raw materials are shown in the following percentage breakdown (based on Table 3):

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	Percent			
	From Communist Countries		From the Free World	
	<u>USSR</u>	<u>Other</u>	<u>Less Developed Countries</u>	<u>Developed Countries</u>
Food and live animals, beverages and tobacco, and animal and vegetable oils and fats	31	37	18	14
Crude materials	39	13	28	20
Mineral fuels	73	25	2	0
Total raw materials	42	25	19	14

7. Czechoslovakia also exports raw materials, mainly to developed Western countries and to Eastern Europe and the USSR. Exports of materials to developed Western countries -- including malt and hops, other foodstuffs, coal, wood, and angora rabbit hair -- are in fact slightly larger than imports. The exchange of materials with Western countries serves to improve the mix of Czech materials, especially in cases where Soviet deliveries fall below expectations. Czechoslovakia exports raw materials to Eastern Europe (especially coal and coke) and the USSR (mainly uranium ore) as a partial offset to their deliveries.* All the countries insist on such offsets. Rumania now gets about as much in the way of materials as it delivers, and Czechoslovakia has an export surplus in materials with East Germany. Otherwise Czechoslovakia

* According to recent public statements, uranium ores are sold to the USSR at prices higher than the current world market. Even so, uranium exports involve a loss, for very low-grade ores must be worked to meet the contract with the USSR.

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Table 3

Commodity Breakdown of Czechoslovakia's Foreign Trade, by Area a/
1966

Million US \$

		Exports					
		To		To			
		Communist Countries		Free World Countries			
SITC Number	Commodity Group	USSR	Other	Less Developed	Developed	Total	b/
0, 1, 4	Food and live animals; beverages and tobacco; animal and vegetable oils and fats	11	21	12	67	110	
2	Crude materials, inedible, except fuels	64	33	10	76	182	
3	Mineral fuels, lubricants, and related materials	0	81	Negl.	35	117	
7	Machinery and equipment	473	530	193	70	1,266	
5, 6, 8, 9	Chemicals; man- ufactured goods classified chiefly by material; miscellaneous manufactured articles; commodities and transactions not classified c/	280	341	111	243	976	

Table 3

Commodity Breakdown of Czechoslovakia's Foreign Trade, by Area a/
1966

		Million US \$				
		Exports				
SITC Number	Commodity Group	To Communist Countries	To Free World Countries			Total <u>b/</u>
		USSR	Other	Less Developed	Developed	
951	Military end items	93	0	0	0	93
	Residual <u>d/</u>	-1	2	0	0	1
	<i>Total</i>	920	1,008	326	491	2,745

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Table 3

Commodity Breakdown of Czechoslovakia's Foreign Trade, by Area a/
1966

Million US \$

		Imports				
SITC Number	Commodity Group	From Communist Countries		From Free World Countries		Total b/
		USSR	Other	Less Developed	Developed	
0, 1 4	Food and live animals; beverages and tobacco; animal and vegetable oils and fats	147	178	87	69	482
2	Crude materials, inedible, except fuels	197	63	141	103	504
3	Mineral fuels, lubricants, and related materials	153	53	3	0	209
7	Machinery and equipment	150	419	3	183	754
5, 6, 8, 9	Chemicals; man- ufactured goods classified chiefly by material; mis- cellaneous man- ufactured articles; commodities and transactions not classified c/	172	266	17	206	661

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Table 3

Commodity Breakdown of Czechoslovakia's Foreign Trade, by Area a/
1966

Million US \$

SITC Number	Commodity Group	Imports				Total <u>b/</u>
		From		From		
		<u>Communist Countries</u>		<u>Free World Countries</u>		
		<u>USSR</u>	<u>Other</u>	<u>Less Developed</u>	<u>Developed</u>	
951	Military end items	96	30	0	0	126
	Residual	0	0	0	0	0
	<i>Total</i>	<i>915</i>	<i>1,009</i>	<i>251</i>	<i>561</i>	<i>2,736</i>

a. The totals for Czech trade with the Communist world and the Free World in the major commodity groups are from Czech trade statistics. The breakdowns between the USSR and other Communist countries and between the less developed and the developed countries of the Free World are estimated, largely from other Czech statistics. The principal trade in military end items, which is here estimated separately, is included under machinery in the original Czech statistics.

b. Because of rounding, components may not add to the totals shown.

c. Excluding military end items.

d. The residual is the combined effect of inconsistencies in the original Czech statistics and of rounding.

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still runs import surpluses in materials with the Communist countries.

8. When exports of materials are subtracted from imports, it is clear that Czechoslovakia depends most heavily on the USSR, which alone furnishes 54 percent of Czechoslovakia's net imports of materials. Other Communist countries furnish 20 percent and the less developed countries another 27 percent.* That is to say, Czechoslovakia depends in the last instance principally on two factors to guarantee its supplies of raw materials. The first is the willingness of the USSR to export much larger amounts of materials than it imports -- as in its trade with East Germany and, on a smaller scale, with Hungary and Poland -- in order to help maintain Soviet influence in Eastern Europe. The second is the fact that most Communist countries and less developed countries are still willing to take Czechoslovakia's manufactures in payment for raw materials.

Direction of Machinery Exports

9. Czechoslovakia's exports of machinery are about equal to its imports of raw materials and go largely to the very areas from which the raw materials come. The demand by the USSR and the Eastern European countries for Czech machinery has slackened, as their competing industries have developed and their interest in acquiring Western machinery has grown. Soviet and Eastern European negotiators have held down the growth of net imports of machinery from Czechoslovakia through stepping up counter-deliveries of their own machinery and by expanding their imports of other Czech manufactures, particularly consumer goods. Net Czech deliveries of machinery to Eastern Europe have dropped in recent years. Net deliveries to the USSR, however, continued to grow rapidly until 1966** and are still equal to about three-fourths of net Soviet deliveries

* The percentages add to more than 100 in this case because there is a negative import (that is, export) balance of 1 percent with the developed countries.

** The drop in the value of net deliveries in 1966 resulted in part from price reductions.

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of materials to Czechoslovakia. The Asian Communist countries have been willing to accept mainly machinery, together with small amounts of other manufactures, including some consumer goods. Machinery makes up more than one-half of deliveries to the less developed countries; consumer goods and other manufactures make up most of the remainder. Czech imports of machinery from the Asian Communist countries and the less developed countries are negligible. Czechoslovakia is of course a large net importer of machinery from developed Western countries.

10. The overall pattern of Czechoslovakia's net trade in machinery and raw materials in 1966 is as follows:

	Million US \$		
	<u>Machinery</u>	<u>Raw Materials</u>	<u>Balance</u>
USSR <u>a/</u>	+323	-422	-99
Eastern Europe <u>b/</u>	+33	-83	-50
Other Communist countries	+78	-77	+1
Less developed countries	+190	-209	-19
Developed countries	-113	+6	-107
<i>Total <u>c/</u></i>	<i>+512</i>	<i>-786</i>	<i>-274</i>

a. Net exports are indicated by a plus sign; net imports by a minus sign.

b. Including Yugoslavia.

c. Because of rounding, components do not add to the totals shown.

Trade in Other Manufactures

11. In other types of manufactures, Czechoslovakia exported some \$300 million more than it imported in 1966. It had an export surplus of about this amount

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in trade in industrial consumer goods alone. In most other types of manufactures -- chiefly metal products, nonmetallic mineral products, and chemicals -- the balances were relatively small. Czechoslovakia's exports in these groups include iron and steel rods, bars, shapes, and sections; pharmaceuticals; ceramics and pottery; textiles and clothing; shoes; furniture; and musical instruments. The chief imports are steel sheet, nonferrous metals, a wide variety of chemical compounds, dyestuffs, fertilizers, and plastics.

12. Most of the trade in these manufactures is with other industrial countries, both Communist and Western, although there are also substantial sales to the less developed countries. The main import surplus with developed Western countries is in chemicals. Czech products in all the main categories of manufactures are sold rather widely in Western as well as in Communist markets, occasionally in quite substantial amounts -- for example, shoes. But they are generally not competitive in design and quality, and there is little advertising or sales promotion.

Price and Quality

13. Any attempt to revive Czechoslovakia's foreign trade must reckon with the widely differing conditions facing Czechoslovakia in trade with the developed countries, the less developed countries, and the Communist world. In the developed West, the Czechs are in competition on the open market. Usually they have difficulty finding customers because they are not well established in the market and their product lines are not designed to meet current demand. The customers that they do find are rarely willing to be dependent on Communist sources of supply and often take only small lots. Finally, the Czech exporter must make major price concessions to close the deal. On the average the prices obtained by Czechoslovakia run to only about one-half those gotten by competing exporters.

14. Czech analysis of UN trade statistics, for example, shows the following comparison of average unit prices received by various exporting countries for machinery exports to Western Europe in 1964:

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<u>Price per Kilogram</u>			
United States	\$4.37	CEMA countries	\$1.04
Western Europe	\$1.92	Czechoslovakia	\$0.95

The Czechs estimate that the composition of machinery exports does not much affect the comparison. It is influenced, of course, by the fact that equipment produced in Czechoslovakia, as in other Communist countries, is generally heavier -- because of inferior materials and obsolete design -- than similar Western equipment. The wide price range for machinery products reflects a strong preference for new and improved products, few of which Czechoslovakia can offer. The Czech competitive position also suffers from slow deliveries and poor parts supply and service and from reluctance to offer credit, although Czech sales involve to an exceptional extent products normally sold on credit in Western markets.

15. The Czechs also face problems when they buy in the West. They often operate from hand to mouth, cannot specify in detail their requirements, and do not have authority to sign contracts without high-level clearance. For these reasons, the Czechs usually pay more than other customers -- by their own calculations close to twice as much. Nothing can be more conclusive on these points than what has appeared in the Czech press. A translation of one article is given in the Appendix.

16. In the less developed countries, Czechoslovakia is still in direct competition with Western businessmen, but the situation is quite different. It is less important to these countries whether the Czech products are the best on the market. Moreover, for political reasons the Czechs have often extended long-term credits to ease the problem of repayment. Finally, Czechoslovakia is more or less prepared to take in exchange raw materials that are not in strong demand on the world market. In some cases -- cocoa beans from Ghana, for example -- Czechoslovakia has accepted goods that it must in turn dispose of at a loss through switch trading. Even under these circumstances, however, Czechoslovakia usually has to sell at substantial discounts below prices of Western competitors in order to get the business. On the other hand, the prices which Czechoslovakia pays for imports are generally at -- not above -- the world price level.

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17. In the Communist world, Czechoslovakia faces still different problems. Trade quotas are established in good part for political reasons, to keep all the economies going and growing. Exporters must still reckon with competition; the least competitive articles tend to get crowded out. But since the overall level of exports is usually increased from year to year as a matter of policy, the effect on most exporters is small. The Communist market has another great advantage from the point of view of the exporting enterprise -- the amounts of goods involved are usually relatively large, representing a major part of sales for many enterprises. Finally, the prices received are almost always much better than can be gotten on other markets.

18. Prices in trade among Communist countries are negotiated on the basis of quotations of various kinds from the Free World. The Communist countries are almost completely dependent on these quotations for negotiating prices. As one Czech spokesman said recently:

I am of the opinion, even though this might seem an exaggeration, that if capitalism were to disappear at this moment with its world market, the CEMA countries would probably not have any prices at which they could trade with one another...

The bargaining over prices involves increasingly sophisticated analysis of varying conditions on Western markets and differences in technical specifications as well as adjustments for transportation differentials. Nevertheless it is fair to say that prices in trade with other Communist countries are roughly similar to those prevailing in the leading world markets and hence much more advantageous to Czechoslovakia than those it actually obtains -- and pays -- in those markets when it deals directly with non-Communist countries.

19. This price cleavage must be an enormous consideration for the Czech leadership. A small trade with the developed West is obviously valuable in spite of the disadvantageous terms of trade.

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Czechoslovakia, like other Communist countries, has used the world market to make up shortages of grain and metals as well as to buy supplementary raw materials. However, trade with the developed West is clearly large enough already to fulfill this purpose. Further shifts to the Western market have been justified as needed to acquire new technology. It is assumed, rather than demonstrable, however, that the payoff on new technology is great enough to offset the disadvantageous terms of trade.

Balance of Payments and Reserves

20. The financial situation of Czechoslovakia offers another reason for a cautious approach to any reorientation of trade. The government has recently been quite frank about the situation. According to Oldrich Cernik, the new Premier (and formerly the head of the State Planning Commission), Czechoslovakia is a creditor, with substantial balances on clearing account both with the Communist world and with the less developed countries. In hard currencies, on the other hand, Czechoslovakia owes about \$400 million, much of it on "short-term credits." The Czechs have drawn about \$175 million (net of repayments) on government-guaranteed loans, mainly from Western Europe. Indebtedness on credits running for a year or less probably does not run over \$50 million. The remainder apparently represents private nonguaranteed supplier credits held by Western banks, mostly running from 1 to 3 years.

21. The leadership has not discussed publicly its position in hard currency and gold. An analysis of balance of payments data from 1948 to date, however, suggests that Czechoslovakia has not accumulated adequate reserves to manage even its present hard currency trade -- with exports and imports both running on the order of \$400 million annually -- let alone any expansion of trade.

22. Czech policy in recent years has been to avoid all risks in trade with developed countries. The object has been to expand Czech exports by as much as possible and to hold down imports, preferably to reduce them. This conservative course merely represents tightened central control and business as usual. It does nothing to solve the underlying problems.

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The Question of Soviet Pressure

23. The people of Czechoslovakia realize that the economy is heavily dependent on the USSR and have watched anxiously to see whether Soviet disapproval of political developments in Czechoslovakia would affect deliveries of vital raw materials. So far that has not happened, but the anxiety remains.

24. In April the Czech radio broadcast some reassuring remarks from CEMA representative (and former Foreign Trade Minister) Frantisek Hamouz, who said that Soviet crude oil (practically the entire supply of Czechoslovakia) had been coming in on time, that hard winter weather and a shortage of trucks had somewhat delayed iron ore shipments (two-thirds of Czech consumption), and that the USSR had offered an additional 5,000 tons of cotton to make up for shortfalls in Egyptian deliveries.

25. Hamouz did not mention the other major commodity delivered by the USSR -- grain. Over the last three agricultural years (1964/65 through 1966/67), Soviet deliveries have provided on the average about three-quarters of Czech grain imports. For a moment in late April 1968 the question arose whether in fact Soviet grain deliveries had been slowed down or stopped. A *New York Times* correspondent, David Binder, reported from Prague, on the authority of a responsible official, that Soviet wheat shipments had been stopped, at least for the current quarter. The government of Czechoslovakia promptly called the report untrue and Binder's source denied that he had said any such thing. The Czechs reported that some 640,000 tons had been shipped in the first four months of 1968. The Soviet press followed up with a news story in late May giving an even higher figure and saying that grain shipments were ahead of schedule. The report indicated that the annual quota of 1.3 million tons would be delivered by the end of August. Whatever delays may have occurred in wheat deliveries, it is almost certain that Soviet pressure was not involved. One fairly conclusive indication that the Czechs were not facing an unexpected shortfall in supplies is that they had just finished negotiating the purchase of 140,000 tons of wheat from Canada, the last contract under a five-year

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agreement, without showing any urgency about getting the wheat or negotiating a new agreement.

26. In all likelihood, the USSR will fulfill this year's trade commitments to Czechoslovakia and will agree to some further increases in deliveries next year. As experience has shown, economic pressure is not effective as a political weapon, even where one country is so dependent on another as Czechoslovakia is on the USSR. The reduction or suspension, selective or comprehensive, of Soviet deliveries would strengthen anti-Soviet feelings in the society and would force Czechoslovakia to turn for help to the West, all without unseating the leadership, whose position, indeed, would probably be strengthened by a wave of patriotic support. Even a country so dependent on trade as Czechoslovakia could continue to function if its imports were largely cut off. The economy would soon revert to a 1945 level, with a big cutback in output by the metallurgical industries, most machinery plants, and the petroleum industry. Unemployment would be substantial. Emergency oil imports would have to be allocated to essential uses; steam locomotives would be brought out of retirement. The soft domestic wheat would be made into flour, and the peasants, who have been feeding this wheat to stock, would have to slaughter much of their herds. But nobody would starve; basic services would continue; and output would pick up as Western help began to arrive.

27. The Soviet government seems to have arrived at the same conclusion, for it decided to use an implied threat of military intervention, plus continued political pressure, to bring Czechoslovakia into line. The USSR will doubtless use economic leverage in trade negotiations for 1969 and for 1971-75, but more for economic than for political ends. Even the withholding of economic aid until political conditions stabilize -- the use of the carrot rather than the stick -- does not carry great political weight.

Trade and Reform

28. Foreign trade problems have been of central importance in Czechoslovakia's long review of

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economic policy, which is approaching the moment of decision. Difficulties in foreign trade have provided the most convincing evidence of what is wrong with the economy. The economic reformers, led by Professor Ota Sik -- now a Deputy Prime Minister -- have focused on foreign trade as the sector in which change must begin. Finally, foreign trade involves political hazards for the new leadership.

29. The Novotny regime was slow to recognize massive inefficiency and technical backwardness as basic problems of the economy, intimately related to isolation from the world market. In the end, the growing preference of Communist trading partners for Western products and the lack of demand for Czech manufactures on Western markets provided evidence that the leadership could not ignore. Once it was recognized how badly the competitive position of Czechoslovakia had slipped under Communist rule, demands for sweeping reform were inevitable. The "recession" of 1962-63 gave these demands political force.

30. Czech economists, though they of course differ among themselves on what to do, agree that major improvements in efficiency depend on returning the economy to the "discipline of the market." Foreign trade plays a key role in their proposals. Most branches of manufacturing are involved in the export market, some quite heavily (see Table 4). Nearly a fourth of the output of manufacturing (excluding the food industry) is exported. So long as enterprises are still protected and constrained by comprehensive trade agreements with other Communist countries -- and by hardly less restrictive arrangements with the less developed countries -- a general shift to the "discipline of the market" is unworkable.

31. In order to overcome this difficulty, the reformers seem to be ready to push changes that would put trade with the Communist world on a more business-like basis, even though the changes would work in the short run to the disadvantage of Czechoslovakia. Their main desire is to decentralize decisions on trade. If trade contracts were negotiated directly between enterprises, exporters would be on their own in a more competitive situation, more like the one

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Table 4

Industrial Exports of Czechoslovakia as a Percent of Output
1966

<u>Branch of Industry</u>	<u>Exports as a Percent of Output</u>
Fuel mining and processing	12.1
Metallurgy, including ore mining	18.3
Engineering	28.4
Chemicals and rubber	17.1
Building materials	10.4
Glass, porcelain, and ceramics	47.8
Woodworking	26.1
Paper	12.4
Printing	13.2
Textiles	15.1
Clothing	21.6
Leather processing	29.1
Food processing	N.A.
<i>Total industry</i>	<i>18.5</i>

they face in the West. Czechoslovakia would pay a price -- with the near elimination of tie-in sales, the volume of trade would drop and the output of many firms would have to be cut back. To put trade

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with other Communist countries on a more business-like basis would help greatly in establishing the "discipline of the market," but at a substantial cost.*

32. Much the same holds for the second main recommendation that the reformers have in mind -- to develop close economic relations with the developed Western countries. As already pointed out, a shift of trade toward the West is bound to be slow and costly, as a result of the lack of demand for Czech products and the extremely unfavorable terms of trade. If trade with the Communist world is put on a more businesslike basis, the differences between selling on Communist and Western markets would be reduced but would still be substantial. The benefit of closer association with the Western market is essentially in acquiring "know-how" -- not only technology but also experience in management, marketing, and finance. These benefits, although expensive, are almost essential to any attempt to make the economy more competitive.

33. Since both these measures -- the adoption of more businesslike trading practices with Communist countries and closer association with developed Western countries -- involve substantial cost, a key requirement of the reform proposals is to obtain enough foreign assistance to finance most of the cost. The reformers have not spelled out in detail what kind of assistance, or how much, might be needed -- although the amounts of \$400 million and \$500 million have been mentioned. But it is evident, first, that immediate help is needed to increase the funds available for conducting hard currency trade; second, that help is needed in



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reorganizing and modernizing the most promising export industries, on a highly selective basis; and third, that very long-term credit is needed to finance deficits in the balance of payments during the introduction of economic reforms, permitting the regime to maintain consumption while restructuring industry and shifting trade patterns.

34. The need for help with financing trade is obvious, and not only to the reformers. The aid sought from the USSR would doubtless be ample to serve this purpose. A substantial Soviet credit is likely to be extended when the Soviet government is finally satisfied of the ability and willingness of the new leadership to keep political opposition in bounds.

35. Western help in overhauling the Czech export industries can probably be obtained once the government has decided what industries to select for this treatment. Long-term loans as well as "joint ventures" are likely to be sought for modernizing export industries and establishing them in the market. Here the regional interests of Slovakia and other vested interests could force a substantial waste of Western help, although the lenders could help to minimize such waste.

36. The acquisition of long-term capital to finance balance of payments deficits is likely to prove the hardest problem. The USSR probably will not furnish enough aid to cover this requirement. A few Western governments -- and the World Bank -- are then the only possible sources. The Czechs have already made approaches to these sources to explore the problems involved. If the new leadership is able and willing to adopt a persuasive reform program, and to satisfy Western lenders that the money will be well used, the money probably will become available. But the leadership faces enormous difficulties in trying to meet these conditions.

37. The political obstacles are, first, the workers' fears of the unemployment likely to result from basic reforms; second, Soviet and Eastern European unwillingness to cooperate in basic changes in conduct of foreign trade; and finally, Soviet

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(and East German and Polish) uneasiness over any rapprochement with the West, especially because of its bearing on the German question.

38. Taken together, these difficulties seem so great as almost to rule out the possibility of basic economic reforms in Czechoslovakia. Professor Sik is now pushing workers' councils a la Yougoslavie in the hope of reassuring the rank and file that their interests will be protected and with a view to getting the central authorities out of enterprise management. Party boss Dubcek himself supports some kind of worker representation. Czech willingness to accept changes in the composition and terms of trade in favor of the USSR might help to win Soviet support for more businesslike trade arrangements. Great caution and tact might enable Czechoslovakia to secure Western economic support without getting into trouble with the USSR. But as of this moment (early June 1968) the odds appear to be against economic reforms as broad as those of Yugoslavia.

Appendix

Prices in Czechoslovakia's Trade with the EEC*

The following are some of the results attained from a comparison of prices obtained by Czechoslovakia in export and import with EEC countries and prices obtained by other countries. In the category of machinery, 10 items were selected for comparison: sewing machines, sorting and crushing machinery, extraction machinery and excavators, pumps for liquid fuels, electric motors and generators, tractors, metalworking machines, bearings, motor vehicles, and looms and preparatory textile machines. The analysis shows that all except the looms and preparatory textile machinery brought lower prices for Czechoslovakia than those obtained by the advanced capitalist countries. The prices obtained by Czechoslovakia for sewing machines, sorting and crushing machines, extraction machines and excavators, liquid fuel pumps, electric motors, and generators were only 20 to 40 percent of the prices attained by the capitalist countries, and the prices of tractors, metalworking machines, bearings, and motor vehicles were only 40 to 60 percent of the prices attained by the capitalist countries.

It should be explained that customs discrimination is not one of the main reasons for the low sales prices of Czech machines on EEC markets. The duties range from 0 to 10 percent, except for motor vehicles, and the advanced capitalist countries which are not EEC members have to pay them too. On the other hand, Czech import prices not only exceed the Czech sales prices but are also higher than the purchase prices of the capitalist countries studied in the survey. For example, in 1960-64, with only one exception, Czech sales prices ranged between 20 and 64 percent of the sales prices obtained by EFTA countries, while comparable figures for Belgium were 60 to 100 percent, Austria 70 to 80 percent, and Sweden about 100 percent. Also in 1960-64, Czech

* Foreign Press Digest, 28 September 1967 (Prague, Politicka Ekonomie, No. 7-8, July-August 1967, pp. 613-629.

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purchase prices ranged between 90 and 260 percent of the purchase prices obtained by EFTA countries, while comparable figures for Belgium were 90 percent, Austria 100 to 120 percent, and Sweden about 100 percent.

These considerable differences cannot be explained merely by the different composition of the assortment within the items studied, since these were relatively homogeneous.

The following tabulation shows sales prices obtained and purchase prices paid by Czechoslovakia for the same category of items in 1964. (All values represent percent of EFTA price, unless otherwise indicated.)

Item	Czech Sales Price	Czech Purchase Price
Sewing machines	44.4	193.6
Sorting and crushing machines	32.2	159.8
Excavation machinery and excavators	40.4	259.3
Generators and electric motors	38.2	182.6
Bearings	59.2	96.5
Passenger automobiles	49.0	84.8
Tractors (1960 figures)	62.4	132
Metalworking machines	43.7	118.4

This situation can be expected to some extent because of the low quality of Czech products and services and because of Czechoslovakia's need to import the types of higher level machinery which it does not produce itself. The sales prices of Czech rolled goods at a low level of processing range between 60 and 100 percent of the EFTA prices, but fall as low as 30 percent for products with a high level of processing. The purchase prices paid by Czechoslovakia in trade with the EEC countries are up to twice as much as the EFTA purchase prices.

Czech sales prices for raw materials and semi-finished goods in trade with the EEC countries are relatively high, ranging between 70 and 100 percent of the EFTA prices. However, even in this case, the

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prices are never higher than those obtained by other countries, and the purchase prices paid by Czechoslovakia for the same items are the highest of all the countries. In 1963, Czechoslovakia paid twice to three times the purchase prices paid by advanced capitalist countries for newsprint and pottery clay.

There has been a tendency, among the advanced capitalist countries, to gradually balance their sales and purchase price relations, but this is not true of Czechoslovakia.

There is considerable variation in the relations of Czech sales prices to EFTA prices for light industry products. For example, the price of glass tableware is very close to the EFTA level, but is only one-half and even lower than the price obtained by Sweden. Sales prices of medicines are the lowest of all, representing only 8 percent of the purchase price for the same item. Czech sales prices of glassware are one-fourth to one-fifth those obtained by Austria. Czechoslovakia's sales prices of cotton fabrics were lower than those of any of the other countries studied, and the purchase prices paid by Czechoslovakia were substantially higher than those paid by the other countries.

The results of the survey show a decline in effectiveness of Czech foreign trade. The relative, and in some cases the absolute, movements of the prices and their relationships are in most cases unfavorable to Czechoslovakia. This is true even in cases where the advanced capitalist countries have improved their price positions.

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MEMORANDUM FOR: The Director

Attached for your information is a recent study on the Czech foreign trade difficulties and the influence this facet may have on developments in that country. In addition to the summary, I recommend, if you have time, that you read the material beginning on page 16 and the Appendix.


Ed Proctor

Attachment:
ER IM 68-82

10 July 1968
(DATE)

STAT

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1 AUG 54 WHICH MAY BE USED.

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